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China's 3D Journey

The Hefei Paradox: Why Smart Industrial Policy Can't Fix Macro Imbalances

Defying optimism that better industrial policy and stronger exports can resolve overcapacity, our Hefei study reveals a hard truth: they can build world-class industries and buy time—but cannot fix the supply-demand imbalance rooted in local government incentives. The real cure: rebalancing reforms.

Why now: With a global capex super-cycle unfolding, there is an increasingly popular debate: productivity-focused, ecosystem-driven industrial policies may be sufficient to sustain growth, by cultivating competitive new industries, capturing structurally stronger external demand, and avoiding the excess capacity traps of the past—even without meaningful economic rebalancing. The 15th Five-Year Plan's "national unified market" initiative and top leadership's latest pledge to [reduce wasteful investment](#) in developing future industries have lent weight to that view.

What Hefei's model tells us: Hefei—the city that rescued NIO, backed CXMT, and seeded China's rise in advanced display manufacturing—is a key showcase for the school of thought that smarter industrial policies can serve as an ecosystem planner, solve bottlenecks of emerging industries, and foster global champions. But even this city has not escaped overcapacity and deflation. Its recipe for success—which counts on timing and bold bets—is not easy to replicate either. Applying the same playbook nationwide risks compounding overcapacity problems.

Why smarter industrial policy and stronger exports are not enough: Better industrial policy can improve investment allocation towards more productive sectors—but cannot, by itself, change the supply-heavy incentives that cause China to invest too much. Stronger exports may offer some relief but have limits: weaker job multipliers, growing economic exposure to the global cycle, and higher risks of protectionism.

What this means for China's economy: We expect China's real GDP growth to [reach 4.8% in 2026 and 4.7% in 2027](#), led by strong exports and related capex amid the global AI and energy transition super-cycle, but domestic consumption would lag—a typical K-shaped economy. The tech-driven new economy continues to strengthen but remains too narrow and capital-intensive to generate broad income gains. The inflation uptick is narrow and largely imported, not demand-driven, and will likely soften again in 2027 as energy effects fade.

The way out: Decisive economic rebalancing reforms to cadre evaluation, fiscal structure, and social safety nets—shifting resources from investment toward household income and consumption.

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A Closer Look

Hefei's growth model—often cited as a showcase of China's industrial success—reinforces a core investment message: China has the ability to foster globally competitive supply chains and champions, but overcapacity and deflationary pressures would persist without structural reforms to fix the supply-centric local government incentives. We expect real GDP growth of 4.8% in 2026 and 4.7% in 2027, driven by exports amid the global AI and energy capex super-cycle, while domestic consumption lags—a K-shaped economy that persists. Reflation is narrow and largely imported, and will likely soften again following the oil shocks. The capex super-cycle is real—but so is the risk that it deepens structural imbalances unless accompanied by economic rebalancing reforms.

Why now

The region's capex is projected to nearly triple in pace, reaching US\$16trn by 2030—driven by AI, energy transition, and defense. China's dominant position in global supply chains places it as a primary beneficiary. This has reignited a macro debate: with the help of structurally stronger external demand, would productivity-focused, ecosystem-driven industrial policy be sufficient to cultivate competitive new industries, and avoid the overcapacity traps of the past—even without meaningful economic rebalancing? The 15th FYP's "unified national market" initiative and top leadership's latest pledge against wasteful investment have lent weight to that view. Meanwhile, CXMT's forthcoming IPO has put its mother city—Hefei—under the spotlight as a key showcase of how good industrial policy can generate national and global champions.

A case study of the "Hefei Model"

Hefei's recipe for success—the government acted as an ecosystem planner, not a blanket subsidy provider: The approach included:

- Mobilizing fiscal resources as patient capital to anchor lead firms,
- Promoting public-private co-investment,
- Building supplier networks around them,
- Conducting market-based exit, and
- Recycling gains into the next strategic sector.

This approach has helped reduced subsidy-induced market distortion and solved funding bottlenecks at the early stage of emerging sector development—when private capital was still hesitant.

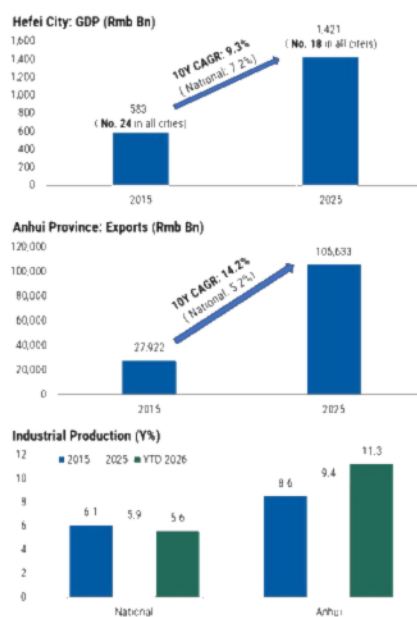
The city has cultivated various national/global champions: It supported BOE in launching China's first sixth-generation TFT-LCD display-panel line, turned the rescue of NIO into the development of an NEV hub in the city, and backed CXMT as a "chain leader" to develop DRAM supply chain when private capital was still in doubt. Today, the city is a major production base across NEVs, displays, and appliances, and hosts globally

competitive players in PV inverters, energy storage, and DRAM.

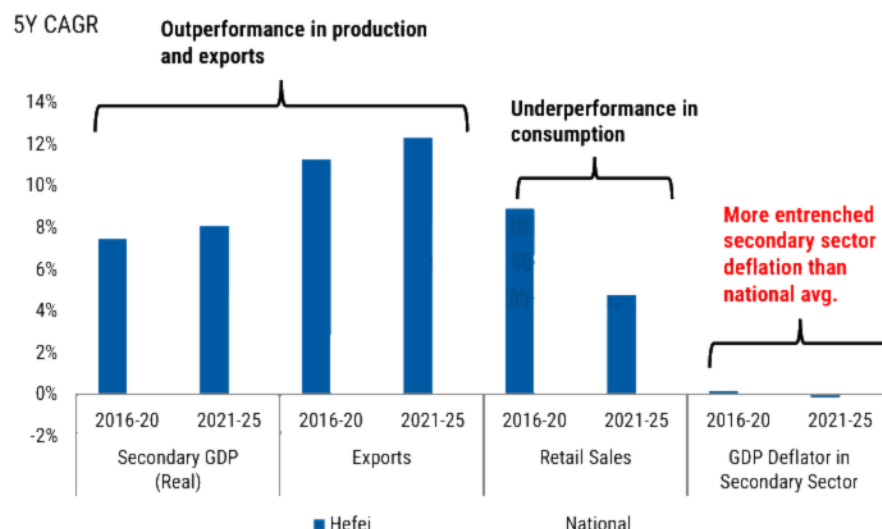
But Hefei's recipe is hard to replicate—and even this city has not escaped overcapacity and deflation: Its success relied on a rare alignment of timing, bold early bets, local industrial fit, and favorable demand cycles that only materialized with a lag. If many regions imitate the same surface tools (large upfront government seed capital, anchor-firm recruitment, industrial park buildout), and focus on the same frontier sectors, this may result in redundant investment nationwide, compounding the overcapacity problem. Importantly, while Hefei has outperformed in industrial output and exports over the past five years, consumer goods sales lagged and price deflation was more severe than the national average.

- *This is a microcosm of China's broader challenge: even with improved industrial policy, the shift is in what China invests in, not how much—leaving the supply-demand gap unresolved.*

Exhibit 1: Hefei has cultivated national and global champions in advanced manufacturing



Source: CL C. Morgan Stanley Research

Exhibit 2: But the city is not immune to overcapacity and deflation problems

Source: CL C. Morgan Stanley Research

Why smarter industrial policy and stronger exports are still not enough

Beijing is increasingly promoting better industrial policy to curb excess capacity in its 15th FYP: Since July 2025, the anti-involution campaign has increasingly targeted disorderly price competition and the flow of investment and credit into sectors with overcapacity. The 15th FYP takes another step ahead by promoting "a unified national market" to address redundant construction and zero-sum competition among local governments. The need to pursue differentiated development across regions and prevent "money-burning" investment has been **re-emphasized by the top leadership** in recent discussion of developing future industries.

The "unified national market" initiative and anti-involution campaign are directionally right—but implementation faces high obstacles: Cross-provincial capacity coordination cannot revert to a top-down model, yet market-based mechanisms for local specialization remain underdeveloped. Cadre evaluation—i.e., performance appraisal system for government officials—still prioritizes output and investment growth. China's VAT-heavy tax system inherently rewards production over consumption. Without changes to these incentives, overcapacity curbs will only reallocate investment across sectors—away from more oversupplied industries toward less saturated ones—rather than toward consumption or social welfare. The supply-demand gap remains wide.

Stronger exports offer some relief... We expect China's export growth to be sustained at 10% this year (vs. 2.2% on average in 2023-25), and see room for its global export share to expand towards 16.5% by 2030 (vs. 15% now), aided by the AI and energy transition-driven global capex super-cycle. The stronger external demand should help mitigate China's excess capacity problem in select sectors.

...but have limits: The transmission from exports to domestic income is weaker than in previous cycles, given a more capital-intensive product mix with lower employment

multipliers. Meanwhile, a growth model that depends on foreign demand to absorb domestic oversupply is inherently vulnerable to global cycle turns and trade tensions.

What this means for China's economy

The K-shaped economy is here to stay: We expect China's real GDP growth to be sustained at 4.8% in 2026 and 4.7% in 2027. The key driver would be strength in the "new economy"—exports and manufacturing capex related to AI, energy transition, and emerging tech sectors. The "old economy" stands in contrast—household consumption would be constrained by a soft labor market and ongoing property adjustment. The new economy is still too narrow and biased towards capital and skills, and rapid AI diffusion risk is widening the gap by raising labor productivity while displacing routine workers in the near term.

The result is strong output but weak transmission to broad income gains, which keeps consumption soft and prevents the new economy from becoming a self-sustaining domestic-demand engine.

Reflation is narrow and largely imported, not demand-driven: Energy costs and AI/green transition demand may push PPI to 1.5% in 2026—its first positive reading in four years. But the improvement has been concentrated in upstream (materials, energy) and AI-related sectors, with limited pass-through to downstream and consumption-linked sectors given weak final demand.

We don't think supply-side consolidation and better exports alone can drive broad reflation. The 2015–17 precedent—often cited as supply-driven success in reflation – was triggered by a massive concurrent demand stimulus (shantytown renovation to fuel household leveraging), yet comparable demand stimulus is not in sight in this cycle.

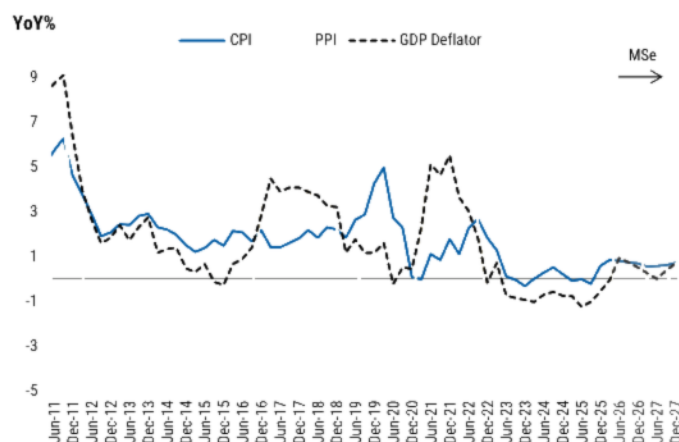
We thus expect PPI to turn negative again in 2027 (–0.4%) as the energy impulse fades, with CPI (0.8% in 2026, 0.6% in 2027) and GDP deflator (0.5% in 2026, 0.3% in 2027) remaining lukewarm.

Exhibit 3: A two-speed economy, stable in aggregate



Source: CLIC, Morgan Stanley Research estimates

Exhibit 4: Surge in PPI likely a one-off level shock; broader prices (deflator) remain lukewarm



Source: CLIC, Morgan Stanley Research estimates

The way out

Decisive economic rebalancing—not better industrial policy—is the core solution: This requires:

- Shifting cadre evaluation from output volume toward household income and consumption,
- Reducing fiscal revenue reliance on VAT in favor of direct taxes that reward efficiency over scale, and
- Strengthening social safety nets to unwind the elevated precautionary savings for consumption.

Progress to date has been incremental: the 15th FYP's consumption push remains qualitative and non-binding, and geopolitical tensions may further entrench Beijing's supply-centric approach.

Without these reforms, improved industrial policy and stronger exports may lift the composition and cyclical trajectory of growth—but *cannot resolve the structural surplus that keeps deflationary pressure alive.*

#1: What is Hefei's recipe for success?

Hefei's model works better than traditional local industrial policies because the government acts less like a blanket subsidy provider and more like an ecosystem planner and VC investor: The approach included:

- Mobilizing fiscal resources as patient capital to anchor lead firms,
- Promoting public-private co-investment,
- Building supplier networks around them,
- Conducting market-based exit, and
- Recycling gains into the next strategic sector.

This approach has helped reduce subsidy-induced market distortion and solved funding bottlenecks at the early stage of emerging sector development – when private capital was still hesitant.

The model has produced visible winners:

- **Displays:** Hefei backed BOE's 6th-generation TFT-LCD line in 2008, filling a key gap in domestic 32-inch panel production and reducing import dependence. It subsequently attracted BOE's 8.5-gen and the world's first 10.5-gen lines, and built a supplier ecosystem spanning materials, glass substrates, equipment, and modules. The cluster underpins Anhui's ~10% share of global display capacity.
- **DRAM:** Hefei funded three-quarters of the initial capital to launch CXMT in 2016—a bet few other cities were willing to make—and built a full supply-chain ecosystem spanning design, equipment, materials, and packaging around it. CXMT is now China's sole DRAM mass producer and the world's fourth-largest. Its forthcoming IPO could deliver multi-fold returns on Hefei's original investment.
- **NEVs:** Hefei invested RMB7bn to rescue NIO from near-bankruptcy in 2020. In return, NIO relocated its Chinese headquarters, core R&D, and supply chain to the city. The bet catalyzed a broader ecosystem: BYD, Volkswagen, and Chang'an subsequently established local manufacturing bases in the city, drawing 500+ component suppliers. This has turned Hefei into a key NEV hub in the nation.

Today, Hefei has emerged as a leading production hub in NEVs, flat-panel displays, and home appliances, and hosts roughly one-third of China's quantum enterprises. Globally, the city is home to firms with leading positions in PV inverters and DRAM, and competitive players in energy storage systems.

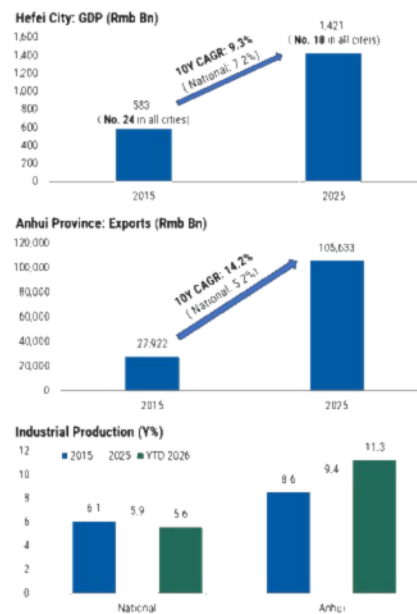
At the macro level, Hefei's real GDP size nearly doubled over the past decade, to Rmb1.4trn in 2025, and its national ranking climbed into the top 18 (from #24 in 2015). The city has now become the primary growth engine of Anhui province, with spillover through vertically integrated supply chains anchored by local champions, extending upstream and downstream production networks across the province, helping sustain Anhui's industrial production and exports to expand at CAGRs of 8.1% CAGR (national average: 5.7%) and 14.2% (national average: 5.2%), respectively, over the past decade.

Exhibit 5: Hefei's model: an ecosystem planner, not blanket subsidy provider



Source: Government website, Morgan Stanley Research

Exhibit 6: Hefei has cultivated national and global champions in advanced manufacturing



Source: CL C, Morgan Stanley Research



#2. Can Hefei's model be replicated by other regions?

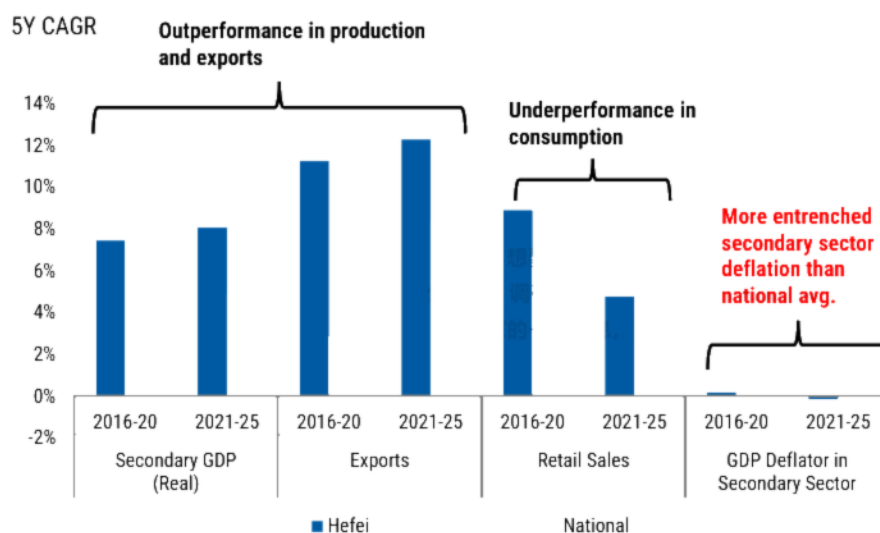
We view this as challenging... Hefei's success came from a rare alignment of timing, bold early state capital commitment, local industrial fit, and favorable demand cycles that only materialized with a lag. Its major bets were made when strategic sectors were still less mature and more fragmented; for example, Hefei invested RMB7bn in NIO in 2020, before China's NEV market entered a far more competitive, shakeout-driven phase. Later followers may face higher entry barriers, less room to attract anchor firms, and more crowded end markets—not to mention that different cities have different local resource endowments.

...and prone to fueling redundant investment across regions: The bigger macro risk is that if many regions imitate the same surface tools—large upfront government seed capital, anchor-firm recruitment, industrial park buildout, and they focus on the same frontier sectors, the result could be redundant investment nationwide, worsening the overcapacity problems Beijing is already trying to curb.

Indeed, even Hefei is not immune to overcapacity and deflation: While Hefei outperformed in industrial production and exports over the past five years, consumer goods sales lagged and price deflation was more severe than the national average—a reflection of overcapacity and constrained corporate earnings despite market share gains. Hefei's case is essentially a microcosm of China's broader industrial challenge: globally competitive supply chains coexisting with compressed profitability and persistent deflation.

- Even with smarter industrial policy, the shift is in what China invests in, not how much it invests—leaving the supply-demand gap unresolved.

Exhibit 7: Hefei is not immune to overcapacity and deflation problems



Source: CLC, Morgan Stanley Research

#3. Can smarter industrial policy reduce excess investment?

Beijing is increasing promoting better industrial policy to curb excess capacity in its

15th FYP: Since July 2025, the anti-involution campaign has increasingly targeted disorderly price competition and the flow of investment and credit into sectors with overcapacity. The 15th FYP takes another step ahead by promoting "a unified national market" to address redundant construction and zero-sum competition among local governments. The need to pursue differentiated development across regions and prevent "money-burning" investment has been [re-emphasized by the top leadership](#) in recent talk on developing future industries.

We view the "national unified market" and anti-involution campaign as directionally right, but implementation could be challenging:

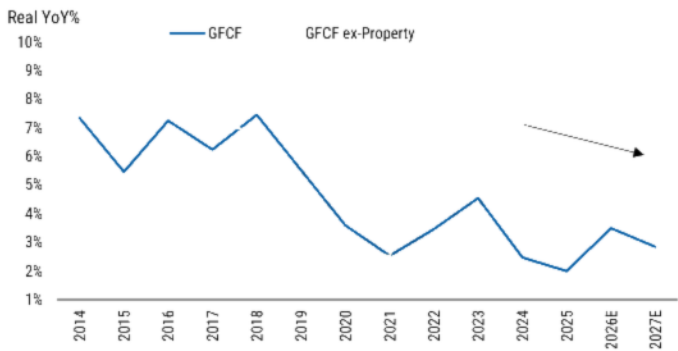
- Cross-provincial capacity coordination cannot revert to a top-down, planned-economy model, yet the market-based mechanisms needed to guide local specialization are still underdeveloped;
- Local government performance metrics continue to prioritize output and investment growth, discouraging officials from ceding industries or pursuing narrower development paths;
- China's tax system, heavily reliant on VAT, inherently favors production over consumption. Aligning local incentives would require a shift toward direct taxes and redesigned central-local fiscal transfers—reforms that are technically complex and likely to proceed only gradually given entrenched local interests.

Without changes to local government incentives, smarter industrial policy will only

reallocate investment, not narrow supply–demand imbalances: As it is, a key reason for the pervasive excess capacity today is the strong industrial sector capex expansion in 2021–23 to partly substitute for the slump in housing investment, keeping overall investment growth strong. Similarly, as local cadre evaluation and tax incentives remain unchanged, the way for local authorities to reduce misallocation and improve "productivity" is to redirect investment support across *industrial* sectors—away from more oversupplied industries toward less saturated ones—rather than re-allocation of fiscal resources from supporting investment to consumption/social welfare spending.

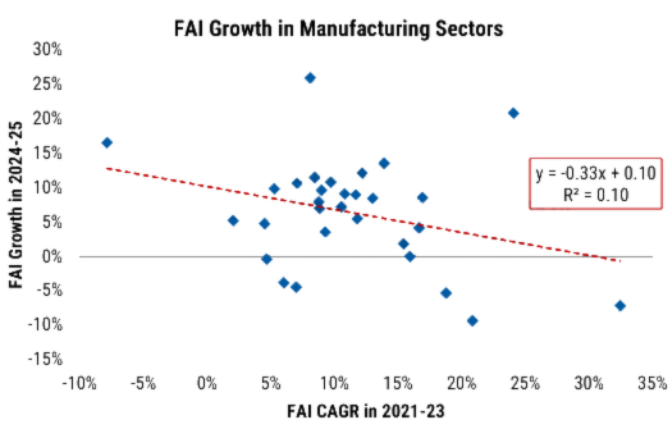
As a result, while overall investment growth has slowed modestly over the past two years, the supply–demand gap remains wide.

Exhibit 8: Investment ex-property growth slowed from 2021-23's spike, but only at a modest pace



Source: NBS, Morgan Stanley Research estimates

Exhibit 9: The "baton" of investment has been passed from sectors with overcapacity to those with less oversupply, for now



Source: NBS, Morgan Stanley Research

#4: Would stronger exports help?

Our chief economist for Asia, Chetan Ahya, believes that the region is entering its strongest industrial cycle since the mid-2000s: The key drivers would be AI and AI-related infrastructure, energy transition, and defence; their second-order demand through the supply chain will likely broaden the cycle further. The team thus expects a 7% CAGR in Asia's capex through 2030, ~3x the pace of the past three years.

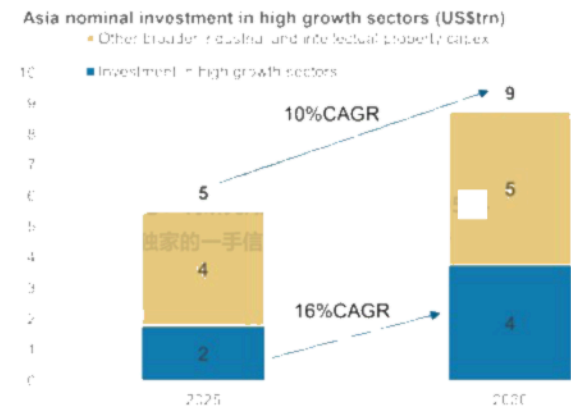
This could provide some relief to China's overcapacity problems: China is set to be one of the primary beneficiaries, given its global leading position across most manufacturing segments. In particular, China commands shares of 70-90% in global production capacity of the "new trio" (EVs, batteries, and solar), which could benefit from the rising global energy-transition demand fueled by the prevailing oil shock.

We thus expect China's export growth to be sustained at 10% this year (vs. 2.2% on average in 2023-25). We see room for its global export share to expand towards 16.5% by 2030 (vs. 15% now). The structurally stronger external demand should help mitigate China's excess capacity problem in select sectors.

However, relying on external demand has limits:

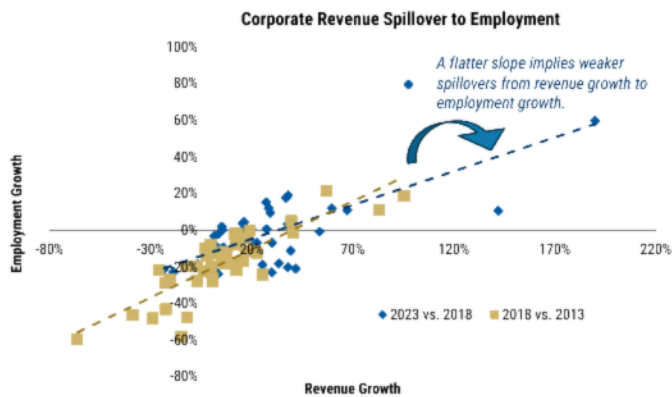
- **Pass-through of export strength to domestic demand is weaker than past cycles:** Our empirical study shows that each incremental dollar of export growth generates fewer jobs than it used to, given that:
 - Manufacturers tend to utilize the existing production lines better, rather than build up factories and hiring, in view of the prevailing excess capacity issues.
 - As export mix has shifted decisively up the value chain towards capital- and technology-intensive industries, its employment multipliers have declined.
- **High reliance on external demand would expose the economy to global cycle...** While gross exports account for only ~20% of nominal GDP, net exports contributed ~30% of real GDP growth in 2024-25 (vs. merely 5% in the previous decade). This would make the economy more sensitive to global cycle swings.
- **...and trade tensions:** A persistently large trade surplus risks renewed protectionism from key trading partners, with the [EU's warning against a potential trade war with China](#) being the latest evidence. While China may partly mitigate shocks via market diversification and trade rerouting, trade barrier re-escalation may weigh on business sentiment and disrupt manufacturing activities.

Exhibit 10: Asia is likely to enter its strongest industrial cycle since the mid-2000s



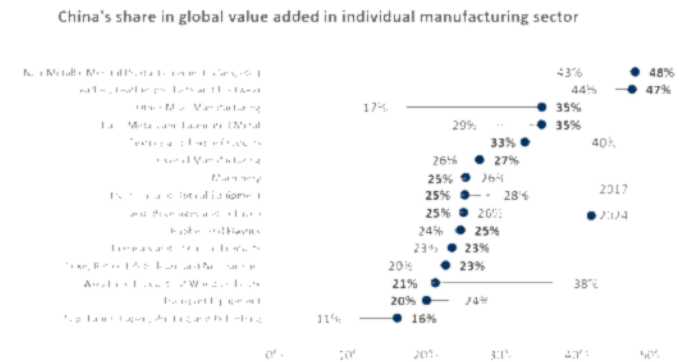
Source: CLIC, Morgan Stanley Research estimates

Exhibit 12: Weaker job multiplier of corporate earnings, given overcapacity and a more capital-intensive export mix



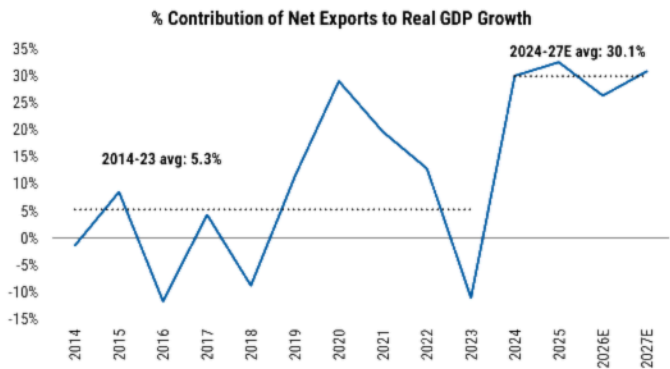
Source: NBS, Economic Census, Morgan Stanley Research

Exhibit 11: China is set to be one of the primary beneficiaries, given its leading position in global supply chains



Source: ADB WGI, Morgan Stanley Research

Exhibit 13: Increased external demand reliance would increase China's vulnerability to global cycle changes



Source: CLIC, Morgan Stanley Research



#5. What is the way out?

The case of Hefei shows that smarter industrial policy can reduce sectoral misallocation and foster winners in emerging sectors, but cannot correct the structural incentives that channel local government resources toward investment over consumption. Stronger external demand may absorb existing inventory, but its transmission to jobs and spending is weaker than before given a more capital-intensive product mix.

In this sense, the core solution lies in rebalancing toward domestic consumption, which requires system-level reforms:

- **Cadre evaluation reform:** Shift verifiable performance metrics away from output volume toward household income, consumption, and environmental quality.
- **Fiscal system reform:** Reduce reliance on indirect taxes (e.g., VAT) that reward scale expansion, and transition toward direct taxes linked to efficiency and profitability. Reorient central-local transfers from project-based allocation to public service provision.
- **Social welfare reform:** Strengthen the safety net to lower precautionary savings (currently ~33% of disposable income). This requires reallocating fiscal resources from investment, increasing SOE equity transfers, and building a multi-tier social security system.

Nonetheless, progress to date has been incremental: The consumption push in the 15th Five-Year Plan remains qualitative and non-binding, and recent geopolitical tensions may lead Beijing to double down on its supply-centric approach to ensure energy security and tech self-sufficiency. Without these reforms, improved industrial policy and stronger exports may lift the composition and cyclical trajectory of growth—but they cannot resolve the structural surplus that keeps deflationary pressure alive.

Exhibit 14: Local government incentives should be reoriented towards consumption



Source: Morgan Stanley Research

Exhibit 15: Five-year plan remains supply-centric

Growth Target

- Not Specified

Consumption

- Commitments to boost consumption/GDP ratio

Tech & Green Transition

Clear numerical targets:

- R&D (5Y CAGR: >7%)
- Labor productivity growth (>GDP growth)
- Digital economy (12pp of GDP by 2030)
- CO2 emissions per unit of GDP (17% by 2030 vs. 2025)
- Additional target on non-fossil fuel consumption

Source: Government website, Morgan Stanley Research